Dividend Dynamics: Assessing the Benefits of Dividend-Paying Stocks

EXECUTIVE SUMMARY

Increased market volatility has placed dividend-paying stocks back into the spotlight. These securities have been long valued for their defensive characteristics during down markets, but their attractive combination of steady income and capital appreciation potential has also delivered consistent, strong returns across full market cycles.

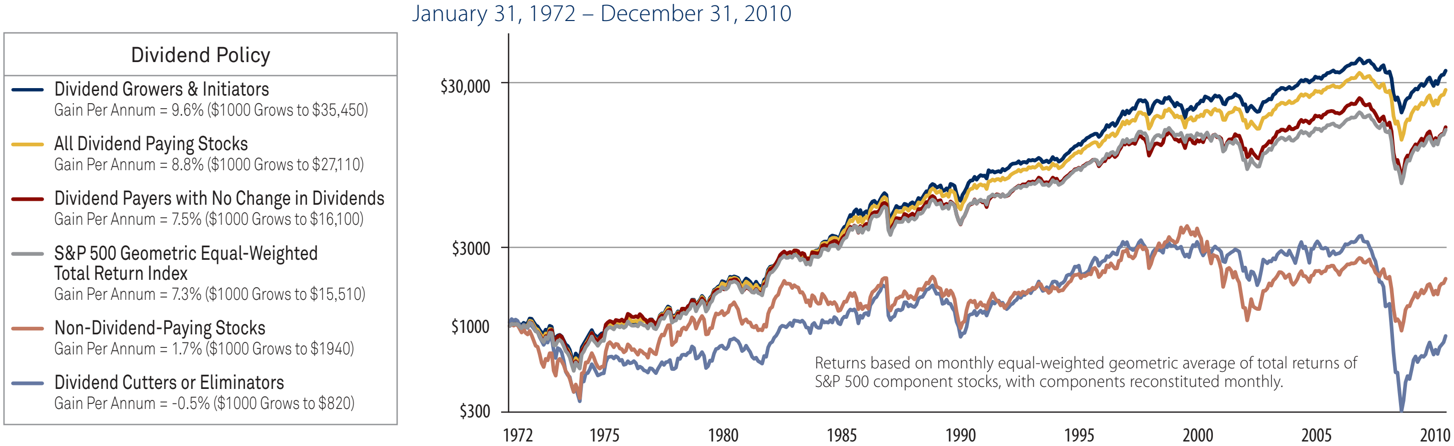
Given this context, equity dividend investing seems particularly relevant in today's market climate. Facing the prospects of slower growth opportunities and more extreme, more frequent market gyrations, investors may be well served by the predictability of dividends to help stabilize – and enhance – their equity returns.

Consider the Benefits of Dividend-Paying Stocks:

- **A Clear Signal of Corporate Financial Health.** Dividends enhance earnings transparency of a company and exert a level of financial discipline on management. They also increase corporate accountability and can be a signal of management's confidence for future growth prospects.
- **Significant Source of Total Return.** Dividend-paying securities offer the potential for both capital growth and income. Reinvested dividends have accounted for nearly 50% of equity total return since the 1930s.
- **Low Relative Volatility.** Dividends have helped buffer portfolio losses when equity prices have declined. Across longer time horizons, stocks with higher dividend yields also have produced stronger returns with considerably less risk than lower dividend-yielding securities.
- **Higher Returns Regardless of Interest Rate Movements.** Regardless of how the Federal Reserve alters monetary policy, dividend-paying stocks have historically outpaced their non-paying counterparts.
- **Downside Protection During Turbulent Market Cycles.** Dividend-paying stocks have outperformed non-dividend payers through both bull and bear markets. This pattern has been even greater for stocks that have grown their dividends over time. *See chart below.*

Growth of $1000 Investment in S&P 500 Stocks by Dividend Policy

January 31, 1972 – December 31, 2010



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Add to this mix a growing number of firms committing to dividend payouts, continued advantageous tax treatment for qualified distributions, and yield compression and accompanying price run-ups in bond markets prompting investors to look for income-generating alternatives, and it is little wonder equity dividend investing is recapturing investor interest. All things considered, dividend-paying stocks appear positioned to enjoy favorable investment tailwinds for some time to come.

HISTORICAL PERSPECTIVE

Investing in dividend-paying stocks has come in and out of favor over the years. During the great bull market of the 1980s and 1990s, capital appreciation accounted for the bulk of equity returns, and investors were willing to forsake dividends since companies were delivering such substantial stock price increases instead.

The investment climate of the decade that followed was starkly different. The 2000s started with severe equity losses prompted by the end of the technology bubble, and investors were reminded that stock prices don't always go up. This painful lesson seemed to be soon forgotten, however, since stocks rebounded relatively quickly and once again began posting impressive price appreciation. All that changed, of course, when the decade ended with the most extreme market decline in generations as the housing crisis and subsequent Great Recession unfolded.

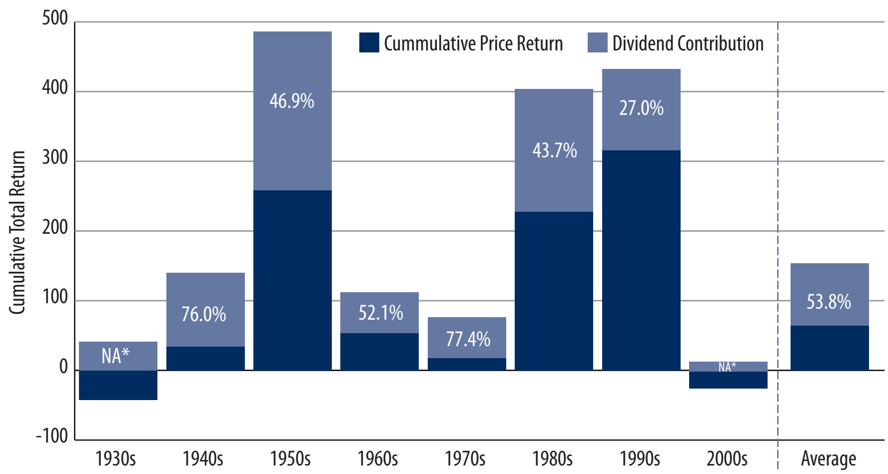
- **Investing in dividend-paying stocks has come in and out of favor over the years.**
- **Today, investors are once again recognizing the crucial role dividends can play in an equity portfolio.**
- **Compounded dividends have accounted for about 50% of overall long-term equity returns.**

Today, with greater volatility the norm and generally more subdued market expectations ahead, investors are increasingly unwilling to rely on capital appreciation alone to fuel their equity investment returns. Consequently, many are once again recognizing the crucial role dividends can play in overall equity performance.

Dividend-paying stocks have generated consistent, positive return streams, regardless of general market movements, and the long-term compounding benefits of dividends have been significant. Exhibit 1 illustrates the contribution of dividends to total return since the 1930s. According to ISI, compounded dividends have, on average, accounted for about 50% of stock total returns. Of particular interest is the important performance cushion dividends provided during difficult economic periods, such as during the 1930s, 1970s and 2000s.

EXHIBIT 1: S&P 500 Dividend Contribution to Total Return

January 1930 – December 2010



Source: ISI. Figures highlighted in dividend contribution reflect dividends as a percent of total return.
**During periods when cumulative price return was negative, dividends as a percent of total return was not calculated.*
Past performance is not indicative of future results.

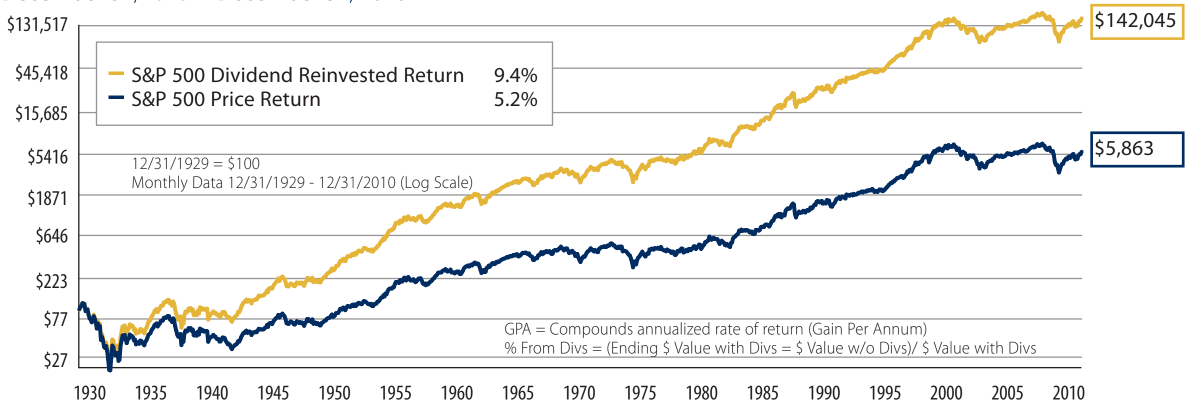
BENEFITS OF DIVIDEND-PAYING STOCKS

Based on the stabilizing effect of dividends on equity performance, we believe many investors will begin to give dividend-paying stocks a more prominent role in their portfolios. Dividend-paying stocks have offered several key benefits that can make them an important part of a successful long-term investment strategy.

- **A Clear Signal of Corporate Financial Health.** A company's ability to pay steady and increasing dividends over time provides tangible evidence of its financial stability and well-being. For this reason, companies are loath to cut their dividend.
- **Significant Source of Total Return.** Dividend-paying securities offer the potential for both capital growth and income. Exhibit 2 presents the S&P 500 Index's dividend reinvested total return and price return since 1930. The compounded effect of reinvested dividends accounted for nearly 50% of total return. Viewed another way, eliminating the compounded dividends would have resulted in an annualized total return of 5.2% compared to 9.4% when they are included.

EXHIBIT 2: S&P 500 Dividend Reinvested Total Return vs. Price Return

December 31, 1929 – December 31, 2010



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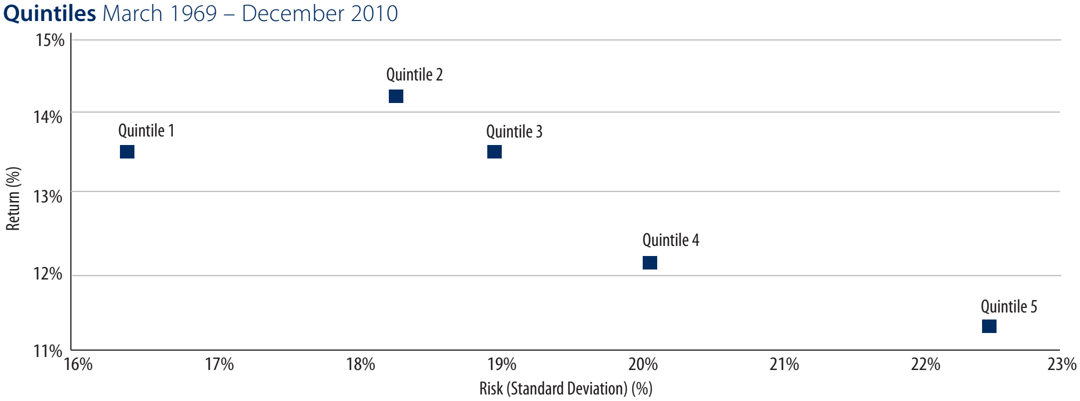
- **Low Relative Volatility.** The risk-adjusted performance of dividend-paying stocks has also been impressive. Exhibit 3 demonstrates the long-term performance of the largest 1,000 stocks by market capitalization, sorted by dividend yields. Higher-yielding securities, represented by quintiles 1, 2 and 3, have delivered stronger returns with considerably less risk compared to lower-yielding stocks (quintiles 4 and 5).

EXHIBIT 3: Annualized Return & Standard Deviation by Highest (Q1) to Lowest (Q5) Dividend Yield Quintiles March 1969 – December 2010

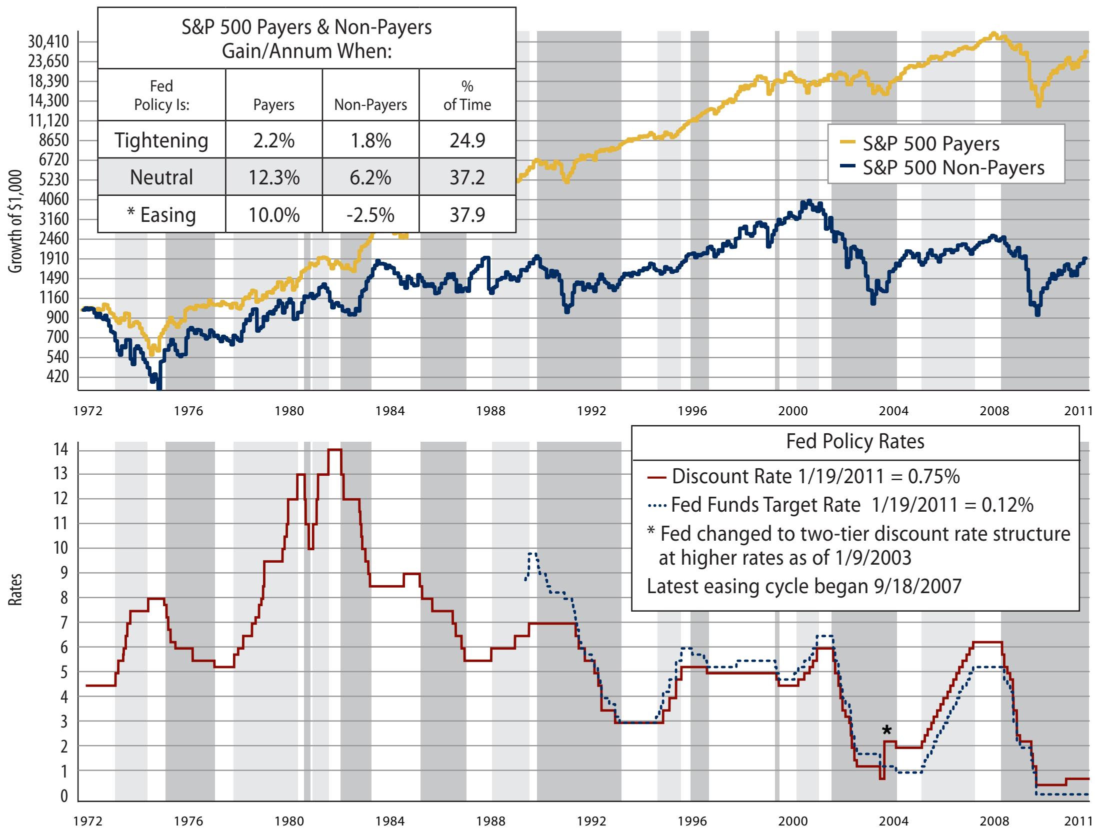


Sources: Barclays Capital Quantitative Equity Strategies, Russell, Compustat, C.R.S.P., February 2011. Represents all data provided by the source. Universe is Largest 1,000 Firms by Market Capitalization. Equal-Weighted Quintiles were Rebalanced Quarterly. ***Past performance is not indicative of future results.***

- **Higher Returns Regardless of Interest Rate Movements.** With interest rates so low, many investors may be concerned about the impact future rate increases may have on equity performance. Exhibit 4 shows that regardless of how the Federal Reserve alters monetary policy, dividend-paying stocks have historically outpaced their non-paying counterparts. For instance, when the Fed tightened monetary policy dividend-paying stocks gained 2.2% vs. 1.8% for non-paying stocks. During periods when monetary policy was neutral or easing, the gain for dividend-paying stocks was even more significant, yielding 12.3% vs. 6.2% in neutral environments and 10.0% vs. -2.5% in easing monetary environments, respectively.

EXHIBIT 4: Dividend Payers vs. Non-Payers in Changing Interest Rate Environments

January 31, 1972 – January 28, 2011



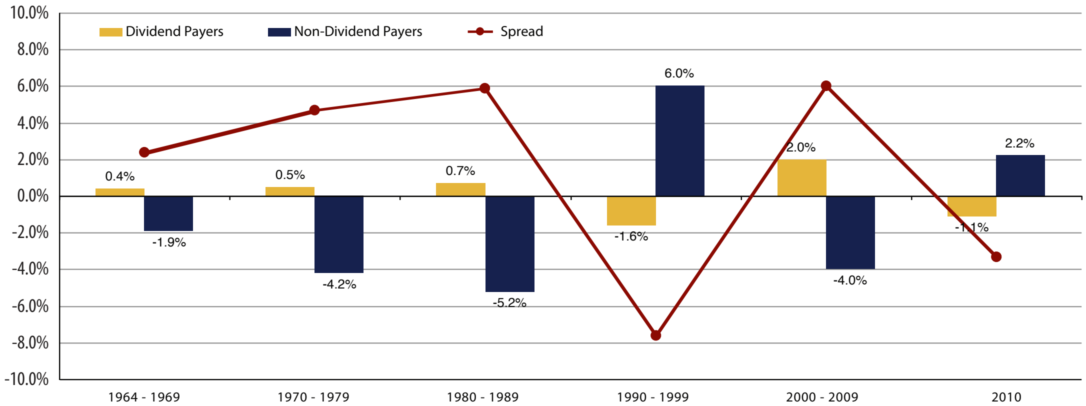
Fed Policy Is:	Payers	Non-Payers	% of Time
Tightening	2.2%	1.8%	24.9
Neutral	12.3%	6.2%	37.2
* Easing	10.0%	-2.5%	37.9

Dark Shaded Areas Indicate Easing Cycles
Light Shaded Areas Indicate Tightening Cycles
Easing Cycle = At Least Two Consecutive Rate Cuts Within a 12-Month Period Without an Intervening Rate Hike
Tightening Cycle = At Least Three Consecutive Rate Increases Without An Intervening Easing Cycles

Source: Ned Davis Research. ***Past performance is not indicative of future results.*** *Until 1989, the Fed used the discount rate as its key benchmark rate, and thus increases or decreases in the discount rate reflected the Fed's monetary policy. The discount rate is the interest rate charged to commercial banks who borrow money directly from the Fed. Since 1989, the Fed has targeted the federal funds rate, which is the rate at which banks borrow short-term funds from each other. While the fed funds rate is a market rate and thus not set explicitly by the Federal Reserve, the Fed maintains a desired target rate for fed funds and through its open market operations (buying and selling government debt) it influences the fed funds rate to keep it close to its target rate. The chart's bottom clip thus also plots the Fed's target fed funds rate from the beginning of 1989 forward.*

- **Downside Protection During Turbulent Market Cycles.** Investors often focus on the defensive benefits of dividend-paying stocks. While consistent dividend payouts have helped temper stock market declines, these securities have also provided historically stronger returns compared to non-dividend-paying stocks across full market cycles. Exhibit 5 below shows that dividend payers have outperformed non-dividend payers in four of the last five decades, a period which included both rising and falling markets. As well, the chart reveals that when dividend payers did underperform, the degree of their underperformance was minimal relative to non-payer underperformance.

EXHIBIT 5: Annualized Performance of Dividend Payers vs. Non-Payers by Decade
January 1, 1964 – December 31, 2010

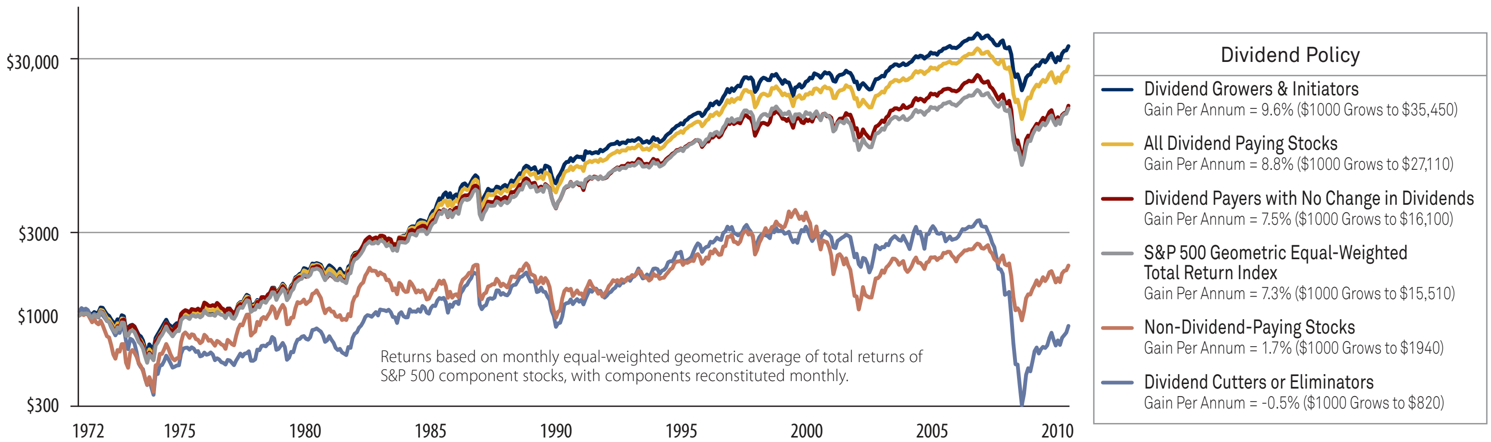


Source: Empirical Research Partners LLC, January 2011. Represents all data provided by the source. Measured over one-year holding periods. Returns are relative to the universe of the largest 750 stocks by market capitalization. ***Past performance is not indicative of future results.***

An analysis of Exhibit 6 reveals that while dividend payers have outperformed non-dividend payers, this trend was even more pronounced in firms that have grown or initiated their dividends. You can see that companies that either grew or initiated a dividend returned 9.6% over the last 38 years. The stocks that maintained their dividend yield over time returned 7.5%. Non-dividend-paying stocks had a gain of 1.7%. Stocks that either decreased or eliminated their distributions were punished by investors and declined 0.5%.

- **Dividend payers have outperformed non-payers in both bull and bear markets.**
- **This trend is even more pronounced in firms that have grown or initiated their dividends.**
- **Stocks that decreased or eliminated their dividend have historically been punished by investors and declined.**

EXHIBIT 6: Growth of $1000 Investment in S&P 500 Stocks by Dividend Policy
January 31, 1972 – December 31, 2010



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The negative return of the stocks that cut or eliminated their dividend suggests to investors that company earnings may be at risk. Earnings help validate the credibility of past reporting and have particular pertinence given increasing accounting complexity and cases of earnings manipulations of the early 2000s. For this reason, corporate management has historically been loath to cut their dividend once a dividend policy has been established.

CURRENT MARKET ENVIRONMENT

The case for dividend-paying stocks is particularly compelling considering the recent market climate and current expectations for the foreseeable future.

Slower Economic Growth

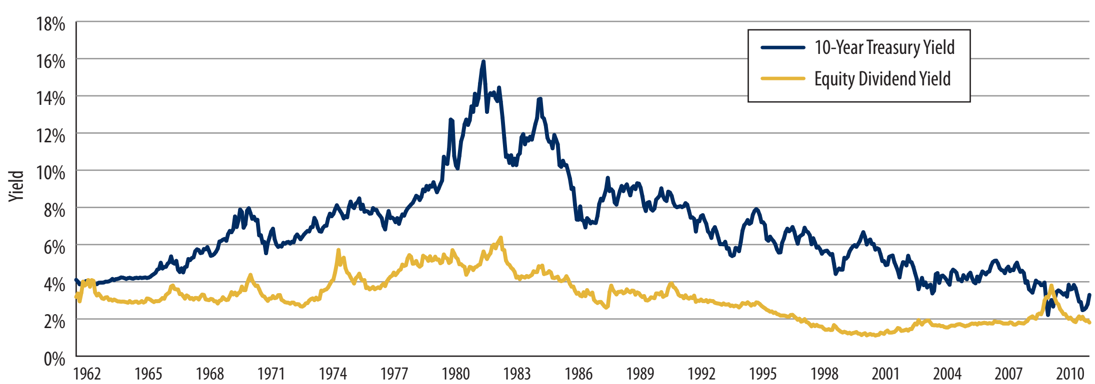
While stock prices generally have rebounded from market lows at the depth of the economic crisis, the path has been far from steady, and the short-term equity outlook has remained uncertain. Concerns about the euro-zone, quantitative easing, stubbornly high unemployment and tepid (although improving) consumer spending continue to worry investors, and it seems probable that full economic recovery is likely to remain out of reach for some time. We believe dividends provide a degree of positive returns, even if stock prices remain volatile or appreciation opportunities are limited by slower economic growth.

- **Current price appreciation may be limited due to market volatility and slow economic growth.**
- **Investors have fewer income-producing investment options due to near-zero interest rates and low yields.**
- **Dividends can help capture a portion of positive returns in uncertain equity markets and may provide diversification to potentially offset bond market declines.**

Fewer Attractive Income Sources

The yields of high-quality, fixed income investments, the typical safe haven during challenging equity environments, have steadily dropped, providing few viable options for investors looking to stabilize portfolio performance while still capturing solid levels of income. At the same time, equity dividend yields have been near the yields of U.S. Treasuries since 2008. (*See Exhibit 7*)

EXHIBIT 7: Equity Dividend Yields vs. 10-Year Treasury Yields
January 1962 – December 2010



Sources: Bloomberg, Standard & Poor's. ***Past performance is not indicative of future results.***

Growing Bond Market Concerns

Over the last several years, investors have poured money into the bond markets, and prices have risen significantly, prompting concerns about a potential bond bubble. There is little to no room for further interest rate declines, and once rates begin to climb higher, or if inflationary risks begin to increase, the impact on bond markets could be devastating. Dividend-paying stocks may help investors diversify their income-generating investments to help protect against a sharp decline in bond prices should these threats begin to materialize.

FAVORABLE OUTLOOK

Looking forward, there are several factors that may make dividend-paying stocks even more appealing to investors. As a result, we expect these securities to represent a greater component of investor portfolios in the years ahead.

More Firms Offering Dividends

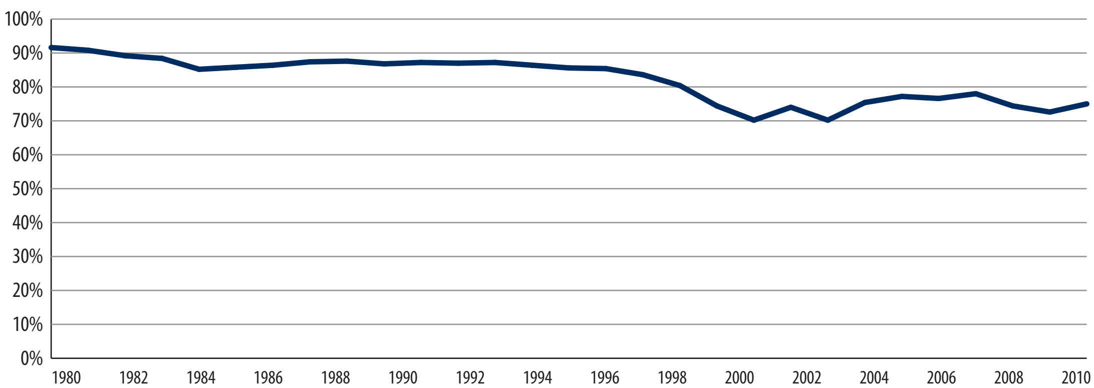
Throughout the recession and recent lackluster recovery, firms have remained extremely cautious, building up sizable cash reserves. Companies are holding a record-high level of about $1,850 billion in liquid assets. The ratio of liquid to total assets is currently 7%, the highest level since the 1960s[1]. In addition, productivity advancements and other cost efficiencies implemented throughout the economic crisis have resulted in higher margins and remarkably strong cash flows.

Consequently, many firms have grown more comfortable committing to dividend payments to help augment equity performance and attract investor interest. According to Standard & Poor's, 256 firms in the S&P 500 Index had a positive (initiated or increased) dividend action in 2010, while only five had a negative (lowered or eliminated) action. This is a continuation of a broader reversal in the volume of dividend-paying stocks. Exhibit 8 illustrates that the percentage of firms in the index paying dividends has trended downward since 1980; however, with the exception of a brief decline during the 2008 financial crisis, this number has been steadily climbing since 2002.

- **Companies have a record level of cash on their balance sheets, the highest since the 1960s[1].**
- **Consequently, they are growing more comfortable committing to paying dividends in order to enhance performance and pique investor interest.**
- **The level of S&P 500 companies paying a dividend has been trending up since 2002, with the exception of a brief decline in 2008.**

EXHIBIT 8: Percentage of Dividend-Paying S&P 500 Companies

January 1980 – December 2010



Source: Standard & Poor's. ***Past performance is not indicative of future results.***

Advantageous Tax Treatment

Congress recently approved a continuation of the favorable dividend tax rate of 15% prompted by the Jobs and Growth Tax Relief Reconciliation Act of 2003. Prior to this legislation, dividends were taxed as personal income and subject to individual tax rates as high as 39.6%. The extension of this tax cut for qualified dividends can enhance after-tax return potential of dividend-paying securities for affluent and other tax-sensitive investors.

Increasing Investor Demand

Dividend-paying stocks should continue to capture the attention of retiring baby boomers and other yield-hungry investors, as well as investors looking to supplement equity performance based on concerns about capital growth prospects. We believe this could result in meaningful price appreciation opportunities.

[1] *"The Balance Sheet Recovery," Tim Bianco and Filippo Occhino, 12.07.10. http://www.clevelandfed.org/research/trends/2010/ 1210/01gropro.cfmt*

CONCLUSION

In an environment characterized by greater stock volatility, low interest rates and slower economic growth, investors may want to consider investing in dividend-paying stocks. The consistent income generated by these securities historically has helped mitigate downside exposure during difficult markets, substantially boost returns during periods of strong performance and deliver superior performance over full market cycles.

- **Looking ahead, the case for dividend-paying stocks remains compelling.**
- **Selecting the right mix of securities requires a careful analysis of yield, valuation and company fundamentals.**
- **The professional insights of fund managers may help capture the strongest opportunities.**

Most investors look to fixed income securities for income potential and stock investments for growth opportunities. Dividend-paying stocks combine these key attributes. By offering a powerful mix of dividend income and capital appreciation potential, dividend-paying stocks have outperformed non-paying stocks with less volatility. What's more, some equity yields are now comparable to select fixed income securities, offering a potential source of income diversification to help protect against a potential decline in bond values once interest rates begin to rise.

Dividends alone, however, do not ensure investment success. Companies that have consistently increased dividends have produced stronger long-term performance. Additionally, firms that have decreased dividend payouts typically have been punished by investors who sell the stock and push the price lower. It is therefore critical to evaluate a firm's dividend payout sustainability, as well as likely capacity for future increases. The most attractive stocks are ultimately determined through a process that includes careful assessment of dividend policy, valuation and company fundamentals, which is why many investors access their equity dividend strategy through a professionally managed mutual fund. Active fund managers offer the expertise and skill to evaluate the risk/reward characteristics of each security relative to its peers, industry and the overall market. These portfolios also typically provide broad security diversification and affordable minimum investments to help investors gain easy access to this appealing segment of the equity markets.

Looking ahead, we believe equity dividend investing will become a greater component of investor portfolios. The risk-adjusted performance of these securities has been compelling, and their outlook has remained favorable. Accordingly, a well-managed portfolio of dividend-paying stocks may prove instrumental to navigating current market challenges and positioning investors for a steadier path to long-term growth.

About RidgeWorth Investments

RidgeWorth serves as a money management holding company with eight style-specific institutional investment management boutiques, each with a well-defined, proven approach and all with unwavering commitments to exceptional performance. Through our multiple, style-specific boutiques, we offer a wide range of equity, alternative and fixed income management investment disciplines.

RidgeWorth Investments, an investment adviser registered with the SEC since 1985, is headquartered in Atlanta, Georgia.

Important Information

This paper reflects the analysis and opinions of RidgeWorth Investments as of February 2011. Because market and economic conditions are often subject to rapid change, the analysis and opinions provided may change without notice. The analysis and opinions may not be relied upon as investment advice. Investors are advised to consult with their investment professional about their specific financial needs and goals before making any investment decisions. RidgeWorth and its employees do not provide legal, estate planning or tax advice.

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In preparing this paper, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from reliable sources.

Investment Considerations

Equity securities (stocks) are more volatile and carry more risk than other forms of investments. Dividends reflect past performance and there is no guarantee they will continue to be paid or that this strategy will be successful.

Investment Terms

- **S&P 500 Index** is an unmanaged index of 500 selected common large capitalization stocks (most of which are listed on the New York Stock Exchange) that is often used as a measure of the U.S. stock market.
- **Standard Deviation** is a statistical measurement of dispersion about an average, which depicts how widely returns varied over a certain period of time.
- **Quantitative Easing** is a form of monetary policy used to stimulate an economy.

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